

BLOCKCHAIN TECHNOLOGY: LEGAL ISSUES TO CONSIDER

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GENERAL

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Highly Novel (“Revolutionary”) Technology with Significant Impact on the Law

- “You should be taking this technology as seriously as you should have been taking the development of the Internet in the early 1990’s.” – **Blythe Masters**
- “The technology likely to have the greatest impact on the financial services industry and the world of business has arrived.” – **Blockchain Revolution**
- Most areas of law (e.g., securities, tax, contract law, etc) are still grappling with basic concepts / application due to the highly novel nature of the technology
- Very little jurisprudence / precedents, but growing

GENERAL

Lack of Regulatory / Legal Clarity Has Become Major Impediment to Growth

- “There is wide agreement that regulatory barriers and government policies are a major impediment to Canada taking a leadership role in the blockchain economy.” – **The Tapscott Group, *The Blockchain Corridor***
- “[R]egulation may present a barrier to market entry and success to Fintech companies.... Although these regulatory frameworks are unquestionably important in safeguarding consumers and mitigating risks..., they can inadvertently deter innovation and the competitive benefits that follow.” – **Competition Bureau (Canada), *“Technology-Led Innovation in the Canadian Financial Services Sector: A Market Study”***
- “Canada could become a global hub for the digital currency sector if the legislative and regulatory environment is conducive to innovation.” –**Canadian Senate, *“Digital Currency: You Can’t Flip this Coin!”***
- Examples: Ethereum, Bitcoin

GENERAL

Lack of Regulatory Clarity is in Part Due to the Tension between Stifling Innovation vs Investor / Consumer Protection

- Regulators recognize significant benefits from the application of the technology
- Regulators are also aware of significant risks and have concerns, which are not unfounded (e.g., fraud, terrorist financing, money laundering, market manipulation). Example: Silk Road
- Desire by regulators to first learn more (before taking action)

LEGAL ISSUES

COMMON LEGAL ISSUES

1. Legal Classification of Digital Assets
2. Securities Law Issues
3. AML / KYC Issues
4. Smart Contracts
5. Cybersecurity
6. Other Areas of Law – Tax Law, Patent Law, etc.
7. Other Practical Legal Issues

1. LEGAL CLASSIFICATION

Legal Treatment of Digital Assets

- **Bitcoin (BTC)** – Security? Commodity? Currency?
 - SEC Chairman Jay Clayton – “... is not a security” *CNBC* (June 6, 2018)
- **Ether (ETH)** –
 - SEC Director William Hinman – “... Ether, based on my understanding of the present state of Ether, the Ethereum network and its decentralized structure, current offers and sales of Ether are not securities transactions.” (June 14, 2018)
- **Others** – Bitcoin Cash (BCH)? Stellar (XLM)?
Monero (XMR)?

Top 100 Cryptocurrencies By Market Capitalization

Cryptocurrencies ▾		Exchanges ▾		Watchlist		USD ▾	Next 100 →	View All
#	Name	Market Cap	Price	Volume (24h)	Circulating Supply	Change (24h)	Price Graph (7d)	
1	 Bitcoin	\$111,031,523,585	\$6,422.18	\$4,402,164,250	17,288,750 BTC	-0.76%		...
2	 Ethereum	\$21,506,606,999	\$210.46	\$2,006,975,805	102,189,764 ETH	-5.10%		...
3	 XRP	\$19,691,613,459	\$0.493884	\$1,560,914,110	39,870,907,279 XRP *	4.99%		...
4	 Bitcoin Cash	\$7,563,813,958	\$435.48	\$389,030,030	17,368,738 BCH	-3.89%		...
5	 EOS	\$4,796,928,646	\$5.29	\$807,550,581	906,245,118 EOS *	-1.90%		...
6	 Stellar	\$4,507,849,423	\$0.239908	\$103,371,038	18,789,946,455 XLM *	-2.42%		...

2. SECURITIES LAW

Regulatory Warnings – e.g., CSA / OSC / IIROC

- **March 8, 2017** – OSC News Release, “*OSC Highlights Potential Securities Law Requirements for Businesses Using [DLT]*”
 - “The [OSC] is advising business that use [DLT] .. that they may be subject to Ontario securities law requirements.”
- **August 24, 2017** – CSA Staff Notice 46-307 – *Cryptocurrency Offerings*
- **June 11, 2018** – CSA Staff Notice 46-308 – *Securities Law Implications for Offerings of Tokens*

2. SECURITIES LAW (CONT'D)

Regulatory Warnings (cont'd) – United States

- **SEC (Select Only) –**
 1. **December 11, 2017** – Statement on Cryptocurrencies and Initial Coin Offerings (SEC Chairman Jay Clayton)
 2. **Jan 19, 2018** – Joint statement by SEC / CFTC Directors of Enforcement on virtual currency enforcement actions
 3. **Jan 22, 2018** – SEC Chairman issued warning to companies that change their name to incorporate bitcoin or blockchain
 4. **Jan 24, 2018** – SEC / CFTC Chairs issued Wall Street Journal op-ed that they are closely monitoring cryptocurrency activities; will take action when warranted
 5. **March 7, 2018** – SEC Statement on Potentially Unlawful Online Platforms for Trading Digital Assets
- **FINRA (Select Only) –**
 1. **August 31, 2017** – “Initial Coin Offerings: Know Before You Invest”
 2. **Dec 21, 2017** – “FINRA Warns Investors: Don’t Fall for Cryptocurrency-Related Stock Scams”
- **NASAA (Select Only) –**
 1. **January 4, 2018** – Statement on NASAA Statement regarding approaching cryptocurrencies, ICOs and other crypto-related investment products with caution (SEC companion statement)

2. SECURITIES LAW (CONT'D)

- **Regulatory Concerns re: ICOs / tokens**

1. CSA: "... in many cases, when the totality of the offering or arrangement is considered, the coins/tokens should properly be considered securities".
2. *Pacific Coast* Test: does the ICO involve: (i) an investment of money; (ii) in a common enterprise; (iii) with the expectation of profit; (iv) to come significantly from the efforts of others?
3. Prospectus requirement / exemptions, disclosure requirements, risk acknowledgement forms, registration requirement

- **Regulatory Concerns re: Cryptocurrency Exchanges**

1. Those that offer cryptocurrencies that are securities must determine whether they are a marketplace. If so, should comply with rules governing exchanges / ATs.
2. Additional possible requirements: identity verification, AML, counter-terrorist financing, market arbitrage / manipulation, recordkeeping.

- **Regulatory Concerns re: Crypto Investment Funds**

- Concerns regarding: (i) valuation (how assess "fair value"; policies when hard forks occur or receive "air drops"), (ii) custody (few, if any, qualified custodians; how validate existence and exclusive ownership of private keys; cybersecurity threats / hacks; etc); (iii) use of crypto-exchanges

3. AML / KYC

Ex: Proceeds of Crime (Money Laundering) and Terrorist Financing Act (PCMLTF)

- Amended in 2014 by Bill C-31 to extend the application of the Act to persons/entities that are “dealing in virtual currencies” (undefined).
- Would require registration as a “money service business” (MSB) and adherence to other requirements (e.g., AML compliance programs, record retention, reporting requirements, etc).
- Provisions are not yet in force. Will come into force once regulations are published.

3. AML / KYC (CONT'D)

- **FINTRAC / FinCEN Existing Guidance (Select Only) –**
 1. **March 2013** – Application to Persons Administering, Exchanging, or Using Virtual Currencies (FinCEN)
 2. **January 2014** – Application to Virtual Currency Mining Operations (FinCEN)
 3. **January 2014** – Application to Virtual Currency Software Development and Certain Investment Activity (FinCEN)
 4. **July 2014** – FINTRAC Advisory regarding Money Services Businesses dealing in virtual currency
 5. **October 2014** – Application to a Virtual Currency Trading Platform (FinCEN)
 6. **August 2015** – Application to Persons Issuing Physical/Digital Negotiable Certificates of Ownership of Precious Metals (FinCEN)
 7. **2014-2016** – FINTRAC Policy Interpretations (PI-6244 and PI-5601)

4. SMART CONTRACTS

Legal Challenges with Smart Contracts

- **Potential risks:**
 - Enforceability (e.g., is wet ink required?)
 - Ensuring that intent of parties is captured in operational clauses (*contra proferentem*; interpret against drafter)
 - How capture “non-operational” concepts: good faith, reasonableness, ‘best efforts’, materiality
 - How capture concepts such as force majeure?
 - Reliance on “oracles” (which oracles to rely upon, data manipulation with oracles, etc)
 - Termination: how ensure contract does not automatically perform when change of law, performance is otherwise illegal, insolvency, or execution of contract is contrary to business common sense
 - Governing law and dispute resolution – which laws apply? Forum to resolve dispute?

5. CYBERSECURITY

- **Bugs in the Smart Contract Code**
 1. Ex: The DAO (see *SEC Report of Investigation*, Release No. 81207 / July 25, 2017)
 2. Flaw in The DAO's code which allowed a hacker to withdraw 1/3 of assets (approximately \$50-60M)
- **Hacking of Related Websites, Crypto-Exchange Platforms, Etc**
 1. ICO website hacks
 2. Hacking of crypto exchange platforms (e.g., Coincheck – \$435 million+)

6. OTHER AREAS OF LAW

- Existing Statutes (e.g., insurance legislation, real estate legislation, etc) – neutralize
- Privacy Law – ensuring compliance with GDPR (“right to be forgotten”) and data protection laws
- Decentralized Autonomous Organizations (DAOs) – legal status?
- Civil / Regulatory Enforcement Issues – how freeze digital assets or cease trade a token? or enjoin / recover assets when identity is unknown?
- Tax Law
- Patent Law
- Consumer Protection
- Governance, etc.

7. OTHER LEGAL ISSUES

Practical Legal Issues Facing Blockchain Companies

- Inability to open bank accounts – possible competition law issues (de-bank / de-risk)
- Requirement on the part of Fintechs to dialogue with not only multiple regulators within a given jurisdiction, but also repeat this dialogue process in multiple jurisdictions
- Etc.

RECOMMENDATIONS

Regulatory Action – Issues to Consider

Issue	Possible Solutions	Examples / Comment
<p>1. Provide Further Regulatory Clarity (Proactive and Collaborative Guidance)</p> <ul style="list-style-type: none"> ➤ <i>Legal status of digital assets</i> ➤ <i>Updates to compliance manuals</i> ➤ <i>Creation / management of pooled fund that invests in digital assets</i> ➤ <i>Creation / management of platform for secondary trading of digital assets, etc</i> 	Request for Comments / Consultation Papers	e.g., BCSC Notice and Request for Comments – <i>Consulting on the Securities Law Framework for Fintech Regulation</i>
	Sandbox Discussions (with immunity) <ul style="list-style-type: none"> ➤ UK, Singapore, Australia 	Offer direct support. Allow experimentation without excessive regulation if remain within boundaries. Reduces regulatory uncertainty + costs. Limits on use of info.
	Commission Studies (evidence-based approach to policy making)	e.g., High Frequency Trading (HFT) study; FINRA’s Report on DLT
	No Action Letters (publish)	e.g., <i>United States</i> : SEC No Action Letters - https://www.sec.gov/fast-answers/answersnoactionhtm.html
	Exemptive Relief Orders	Only a handful issued to date.
	Conferences / webcasts	e.g., FINRA Blockchain Symposium, or “A Few Minutes with FINRA”

Regulatory Action – Issues to Consider

Issue	Possible Solutions	Examples / Comment
<p>2. Develop Better Mechanisms to Facilitate Dialogue with Regulators</p> <ul style="list-style-type: none"> ➤ <i>Uneconomic / time consuming dialoguing with multiple regulators</i> ➤ <i>Need regulatory collaboration and unified approach</i> 	<p>Identify Fintech Policy Lead</p> <p>Create multi-org Regulatory Sandbox with federal / provincial bodies (e.g., OSFI, OSC, Bank of Canada, IIROC, FINTRAC, etc), with <u>international collaboration (“bridges” or “landing pads”, and global guidelines)</u></p>	<p>e.g., Delaware Blockchain Ombudsperson</p> <p>e.g., UK’ Project Innovate, Singapore’s Smart Financial Centre, Australia, etc – have a unified financial sector regulatory framework; can take national, unified approach to encourage FinTech development.</p> <p>e.g., Global Financial Innovation Network (GFIN) – Dubai, Singapore, Ontario, UK, etc</p>
<p>3. Work with Stakeholders to Develop Solutions to Key Legal Issues Restricting Development of DLT Projects</p> <ul style="list-style-type: none"> ➤ <i>Address AML/KYC, anti-terrorist financing and other concerns</i> 	<p>Whitelist freshly mined / minted cryptocurrencies</p> <p>Risk ratings (e.g., Chainalysis)</p>	

Regulatory Action – Issues to Consider

Issue	Possible Solutions	Examples / Comment
<p>4. Statutory / Regulatory Reform: Modernize Regulation</p> <ul style="list-style-type: none"> ➤ <i>Technologically-neutral and device-agnostic regulation</i> ➤ <i>Principle based regulation</i> ➤ <i>Efforts to harmonize across jurisdictions</i> 	<p>Update / neutralize rules and legislation to address blockchain, smart contracts, etc.</p>	<p>e.g., Delaware corporate law amendments – can now use DLT to maintain stock ledgers, communicate with stockholders, issue / maintain shares on the ledger</p> <p>e.g., Arizona, Tennessee, etc – smart contract legislation (CDC: unnecessary)</p>
	<p>Develop specialized frameworks or licensing regimes for blockchain, where required</p>	<p>Need to be flexible and proportional to the risk.</p>

Regulatory Action – Issues to Consider

Issue	Possible Solutions	Examples / Comment
<p>5. Enforcement</p> <ul style="list-style-type: none"> ➤ <i>Enforce against bad actors</i> ➤ <i>Avoid regulation by enforcement</i> 	<p>Publish investigation reports or warning letters</p>	<p>E.g., SEC’s Report of Investigation: DAO</p>
<p>6. Positive Posture</p> <ul style="list-style-type: none"> ➤ <i>Foster innovation; avoid stifling</i> ➤ <i>Lead by example</i> 	<p>Positive campaign</p> <p>Experimentation with blockchain (pilot projects, proofs of concept)</p>	<p>Singapore “Smart Nation”, Dubai 2020, Switzerland</p> <p>Use in combatting insider trading, assist in AML/KYC compliance, etc.</p>

QUESTIONS?

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